Section 3 Efforts to recover and enhance Japan’s locational competitiveness

The impact of the Great East Japan Earthquake went so far as to cause some foreigners and foreign-affiliated companies/government agencies to escape from Tokyo for a period. Although the move of large-scale evacuation has come to a halt, there is concern that Japan has become less attractive as a business location for foreign companies in the medium term due to such factors as the continued problem of electricity shortages and concerns over radiation levels. There also emerged the possibility that Japanese companies would become more active in their attempts to diversify their investments into Asia and other parts of world from the perspective of coping with the risks of natural disasters. In order for us to recover and increase the business/investment flow into Japan, we need to make further improvements in our business environment. This section discusses our efforts to enhance Japan’s locational competitiveness, referring to the earthquake disaster's impacts and measures to improve them.

1. Effects of the Great East Japan Earthquake

The concerns about radioactive contamination and electricity shortages resulting from the earthquake disaster and nuclear power plant incident (accident?) caused many foreign companies and government agencies to temporarily evacuate from Tokyo and some other places. Although this has come to a halt, there is a concern that Japan’s locational competitiveness will decline in the medium to long run because of the fall in domestic demand as well as the continued concern about the electricity supply.

(1) Foreign-affiliated companies’ moves

Following the earthquake disaster and the nuclear power plant accident, some foreign companies took measures such as the temporary closing of their business bases in the coastal regions of East Japan and the transfer of employees overseas or to the Kansai region. But since the end of March 2011, they have begun to gradually resume their operations, while an increasing number of foreign-affiliated businesses have returned their headquarters functions to Tokyo. Here are some examples of foreign-affiliated companies’ moves shortly after the earthquake disaster: Foreign Company “A” had most of its foreign staff return to their home country with their families (March 23); Foreign Financial Institution “B” transferred its employees (about 10 persons) to Hong Kong and Singapore (March 23); Foreign Retailer “C” temporarily closed its three stores in Kanto (March 28); and, Foreign Retailer “D” temporarily closed its ten stores in Kanto (March 28). Furthermore, at Restaurant Chain “E,” the number of foreign part-time workers decreased from about 800 to 600. About 270 financial workers withdrew to Hong Kong, while at English Conversation Company “F,” about 40% of 800 foreign teachers returned to their home countries or moved to Kansai.

On the other hand, some foreign financial institutions jointly declared that they would continue their business operations[1]. Foreign Financial Institution "G" coped with the situation calmly through such measures as inviting nuclear specialists and having them brief its employees about the situation. While there are many moves to resume normal operations as the actual situation becomes clearer to the people, there is also concern that the effects of the suspension/revision of investment plans, changes in procurement sources, etc. will manifest themselves gradually.

(2) Moves of foreign government agencies in Tokyo

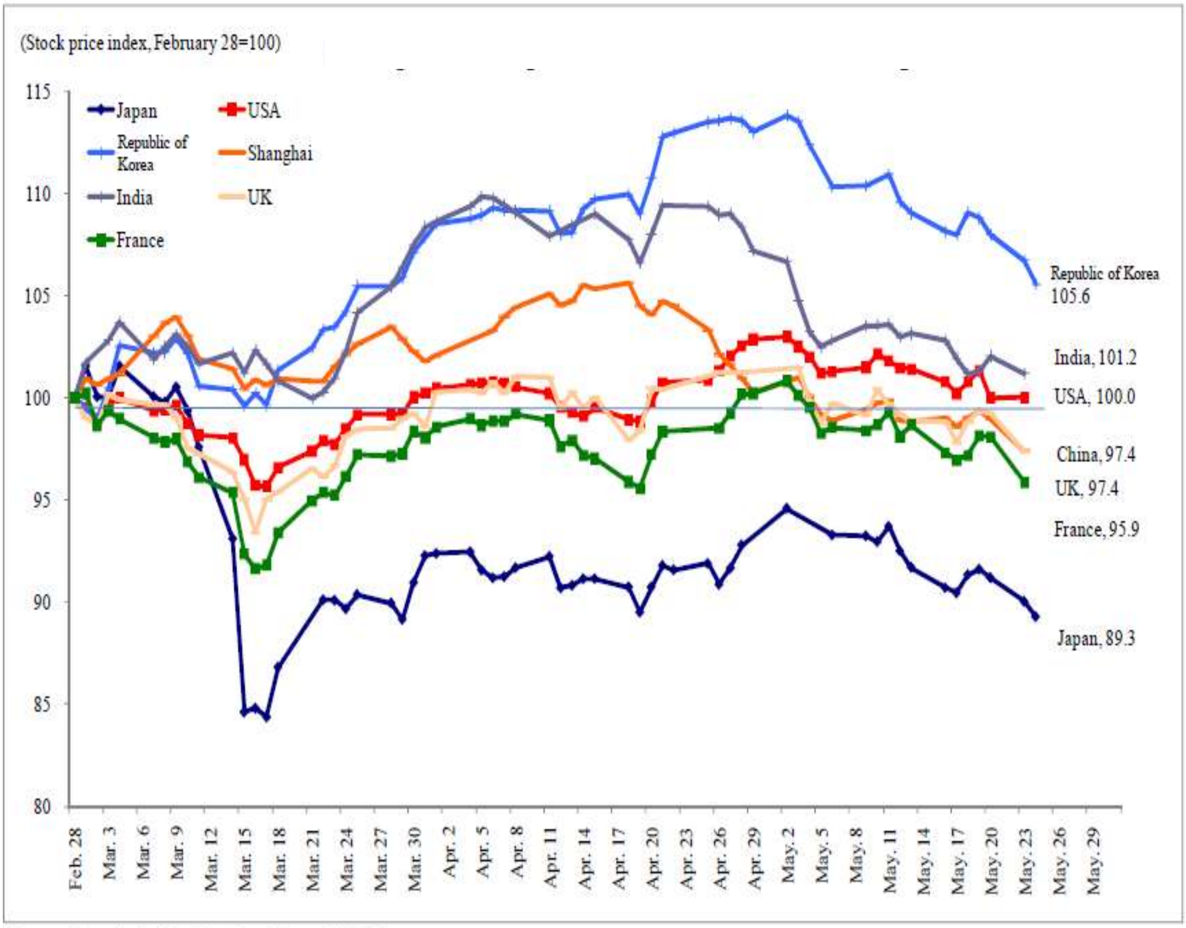
After the earthquake and nuclear power plant incident, 32 countries (1 Asian, 5 European, 4 Latin American, 3 Middle Eastern, and 19 African countries) closed their embassies in Tokyo temporarily, and moved the functions to Western Japan or overseas. Such moves peaked at the end of March, after which the embassies were gradually returned to Tokyo. By the end of May, all foreign diplomatic officers had resumed their operations in Tokyo.

(3) Stagnant stock prices

The downward trends, experienced in many stock markets around the world after the March 11th earthquake disaster, were reversed after a while. But, among the laggards of the world, the Japanese stock market has been particularly stagnant in spite of the continued buying by foreigners (see Figure 5-3-1-1). Japan-related CDS costs have stabilized after rising sharply in the immediate aftermath of the earthquake, but they still remain relatively high. The stagnant share prices can be attributed to the fall in domestic demand stemming from the earthquake disaster as well as to the effects of electricity shortage on industrial production. It is feared that such an economic stagnation may accelerate the downward trend in Japan's locational competitiveness in the medium to long run.

[1] Press release by the International Bankers' Association dated March 15.

Figure 5-3-1-1 Changes in stock prices before and after the earthquake disaster



Source: Compiled using data from Reuter 3000 Xtra

2. The state of inward direct investment before the earthquake disaster

(1) Significance of inward direct investment

Foreign companies, operating in Japan, are expected to bring new technologies, managerial know-how, and investment. Such technologies could be transferred to Japanese companies through M&A and business partnerships, among others. The productivity of many of the foreign companies tends to be higher than that of their Japanese counterparts, and there is a tendency that firms, newly acquired by foreign companies, often see their productivity improving. During 1994-1998 the total production of foreign-affiliated companies in Japan expanded to 9 trillion yen, and most of this expansion resulted from M&A activities of foreign companies[2]. In recent years (2000-2005), the improvement of foreign-affiliated companies' productivity is mainly attributable to green field investment[3]. Transfer of new technologies and managerial know-how can help improve Japanese companies' productivity[4].

Moreover, newcomers to the Japanese market, including foreign companies, tend to be more active in capital investment than older, more established companies, thus contributing to the creation of jobs both directly and indirectly. Their active employment behaviors are distinct from those of more established companies[5].

(2) The number of foreign-affiliated companies and the state of inward direct investment before the earthquake disaster

In the Japanese market the number of new entrants owned by foreigners has declined in recent years, while the number of withdrawals has been increasing (see Figure 5-3-2-1). In 2004 the number of new entries (139 companies) exceeded that of withdrawals (106 companies), but in 2009 the number of withdrawals (164 companies) far surpassed that of entries (82 companies).

In addition, the ratio of inward direct investment to GDP is extremely low (3.9%), compared with those for other countries (such as 15.8% for the U.S. and 46.5% for the UK) (see Figure 5-3-2-2).

Furthermore, Japan's business attractiveness, as viewed by foreign companies, has been declining sharply in recent years. According to a 2009 survey, Japan lost its top position in Asia even in categories such as "regional headquarters in Asia" and "percentage of R&D centers"

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[2] Fukao, K (2004), "CHOKUSETSU TOUSHI TO NIHON KEIZAI", reported at the Japan Center for Economic Research

[3] Fukao, K and H. U. Kwon (2010), "NIHON KEIZAI SAISEI NO GENDOURYOKU O MOTOMETE"

[4] Fukao, K, K. Itou and H. U. Kwon (2005), "TAINICHI CHOKUSETSU TOUSHI WA NIHON NO SEISANSEI KOUJYOU O MOTARASUNOKA? "KIGYOU KATSUDOU KIHON CHOUSA" SHUUHYOU DATA NI MOTOZUKU JISSHOU BUNSEKI"

[5] Fukao, K and H. U. Kwon (2010) "NIHON KEIZAI SAISEI NO GENDOURYOKU O MOTOMETE"

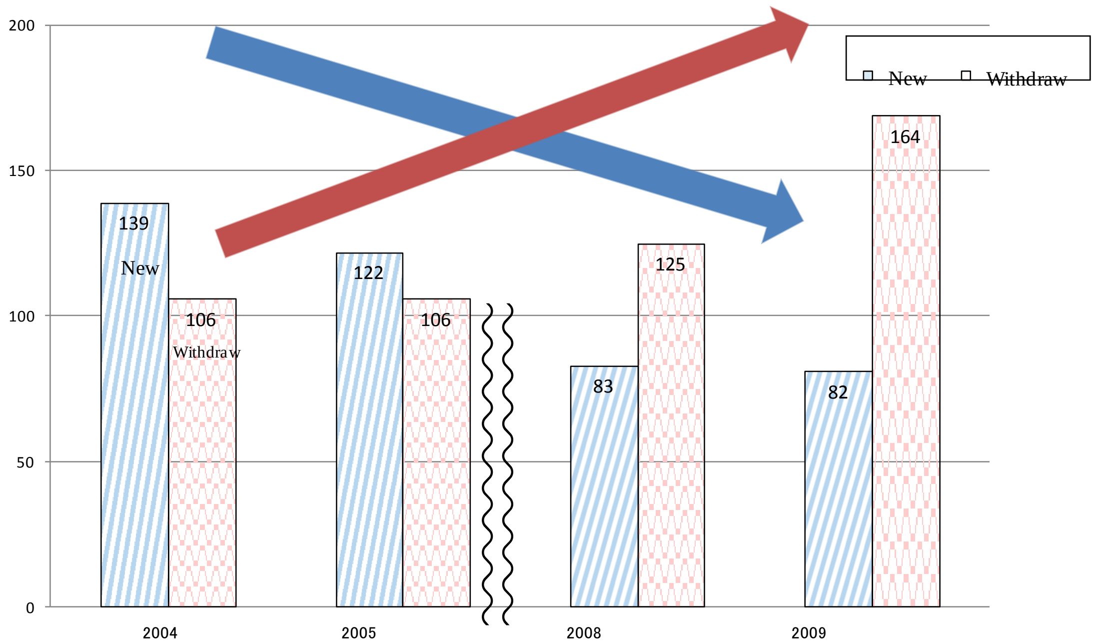
(see Table 5-3-2-3, Table 5-3-2-4).

Questioned about Japan's locational problems, foreign companies most frequently cited "high business costs" (71.2%), followed by "closed/special nature of the market" (61.9%) and "highly demanding customers with regard to the quality of goods and services" (60.7%) (see Figure 5-3-2-5).

The earthquake disaster may undeniably worsen foreign companies' views of the Japanese investment environment.

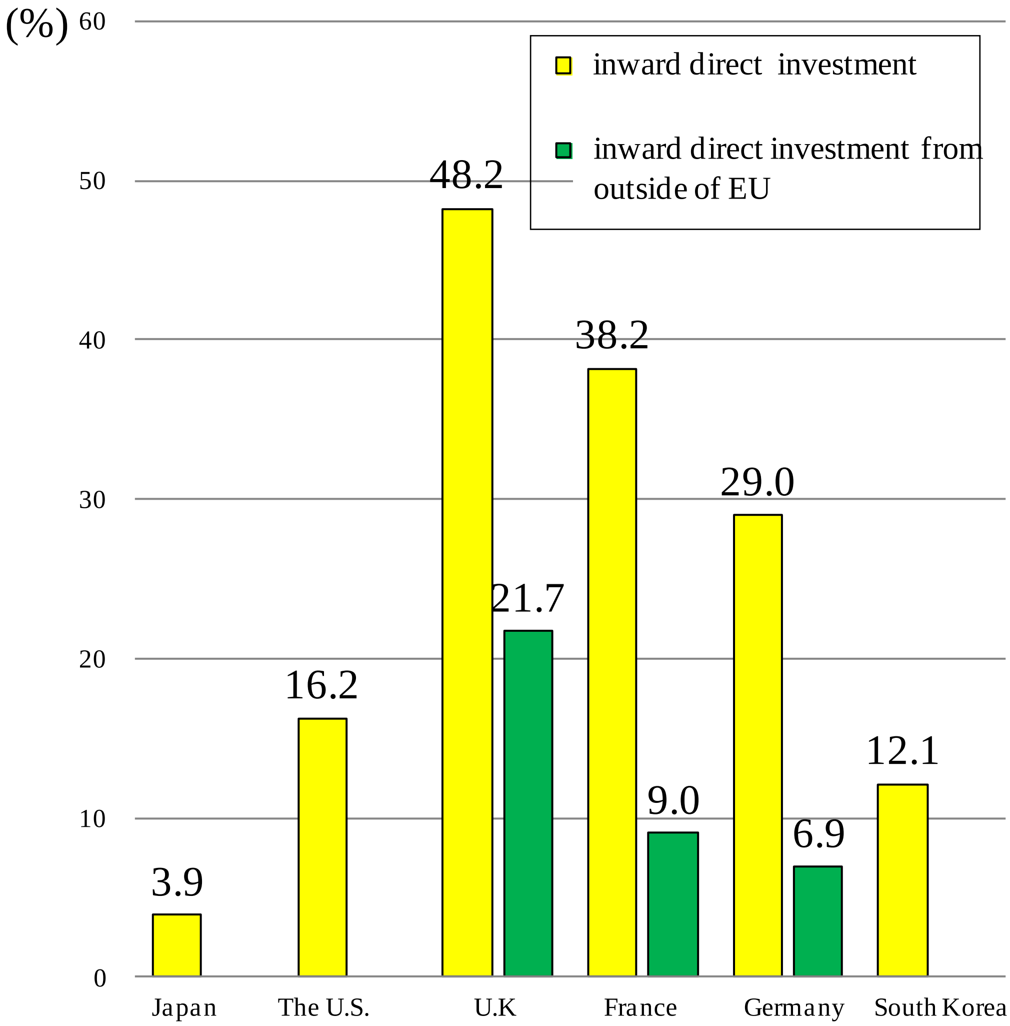
Figure 5-3-2-1 Change in the number of new entries and withdrawals by foreign firms in Japan

(Unit: corporation)



Note: "Withdraw" includes "dissolution" and "reduction of ratio of foreign capital (for example, lower than one third)".
Source: Compiled from "Survey of Trends in Business Activities of Foreign Affiliates" of METI.

Figure 5-3-2-2 Domestic direct investment in proportion to GDP by country (end of 2009)



Note: Outside of UE of Germany is at the end of 2008.
Source: Compiled from IMF "International Financial Statistics", "Survey of Current Business", "La Balance des Paiments et la Position Exterieure" and so on.

Table 5-3-2-3 The most attractive countries and regions in Asian region according to each function (2007)

	Japan	China	India	Singapore	South Korea	Hong Kong
Central headquarters for Asia region	①23%	18%	8%	16%	4%	②20%
Manufacturing base	3%	①62%	②12%	2%	5%	5%
R&D base	①30%	②25%	16%	9%	4%	6%
Back office	②15%	①24%	②15%	12%	5%	②15%
Distribution base	11%	①41%	8%	9%	7%	②13%
Financial base	–	–	–	–	–	–
Sales base	–	–	–	–	–	–

Notes: Percentage of companies selecting a country for each function. Percentage points out of 209 responding firms (including 51 firms that have already entered Japan) excluding non-responsive firms (78 in Europe, 74 in North America and 57 in Asia).

Source: Compiled from the "Survey on Attitudes of Foreign-Affiliated Companies toward Direct Investment in Japan 2007," conducted by METI.

Table 5-3-2-4 The most attractive countries in Asia according to each function (2009)

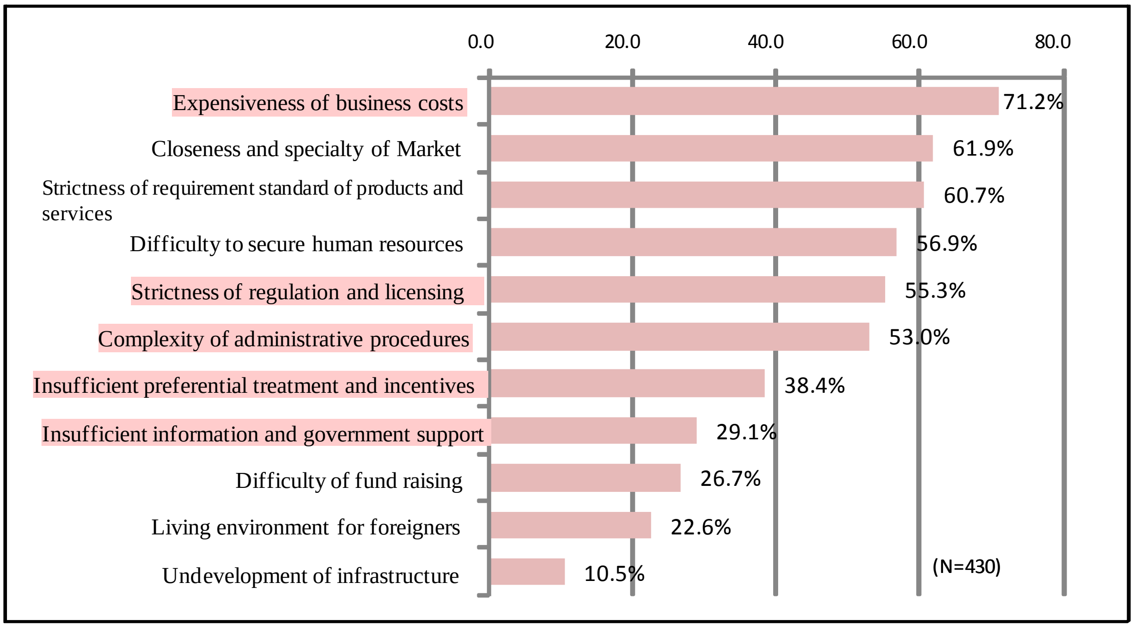
	Japan	China	India	Singapore	South Korea	Hong Kong
Central headquarters for Asia region	10%	①42%	10%	②16%	2%	13%
Manufacturing base	1%	①64%	②14%	2%	2%	2%
R&D base	②21%	①33%	20%	8%	4%	2%
Back office	8%	①39%	②19%	15%	2%	9%
Distribution base	3%	①63%	8%	② 11%	2%	6%
Financial base	10%	①30%	9%	21%	4%	②23%
Sales base	7%	①50%	7%	11%	4%	②13%

Notes: Percentage of companies selecting a country for each function.

Percentage points out of 180 responding firms (60 in Europe, 60 in North America and 60 in Asia, including 30 firms that have already entered Japan).

Source: Compiled from the "Survey on Attitudes of Foreign-Affiliated Companies toward Direct Investment in Japan 2009", METI

Figure 5-3-2-5 Perceived problems concerning location in Japan from the viewpoint of foreign firms

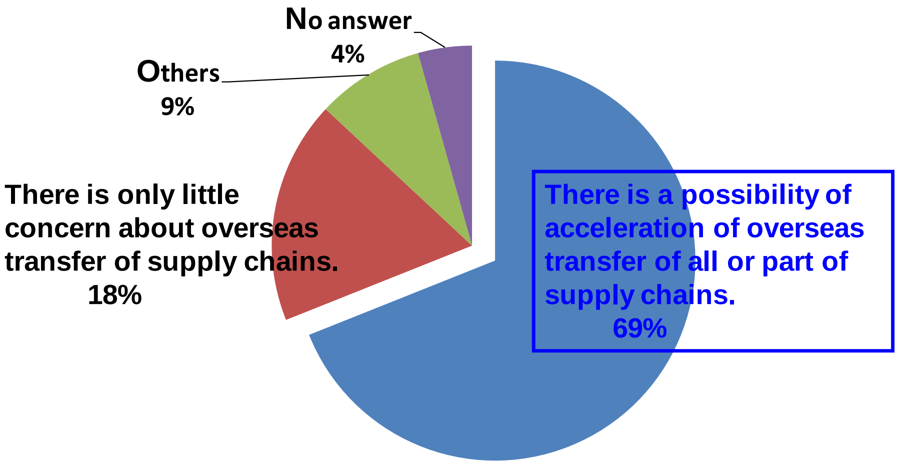


Notes: 430 firms responded (multiple answers possible).
3-level evaluation of “(a) significant obstacle", "(b) moderate obstacle" and "(c) not an obstacle" was carried out, and the ratio of firms that responded with (a) and (b).
Source: Compiled from the “2009 Survey of Sentiments of Foreign Companies" conducted by METI.

(3)Effects of the earthquake disaster on Japanese companies’ investment attitudes

According to a METI survey which asked Japanese companies “if there a possibility that overseas transfer of supply chains will be accelerated by the recent earthquake disaster”, 69% of respondents said that “there is a possibility that the overseas transfer of all or part of the supply chains may accelerate”, while only 18% replied that “there is only little chance of overseas transfer of supply chains” (see Figure 5-3-2-6). If Japan’s locational competitiveness deteriorated as a result of the earthquake disaster, this kind of trend might be strengthened, adversely affecting the investment in Japan not only in the short run but also in the medium term.

Figure 5-3-2-6 Possibility of acceleration of overseas transfer of domestic firms due to the earthquake disaster



3. Efforts to improve Japan's locational competitiveness

(1) "New Growth Strategy"

The "New Growth Strategy: Blueprint for Revitalizing Japan", approved by the Cabinet on June 18, 2010, refers to "Reducing the Effective Corporate Tax Rate and Promotion of Japan as an Asian Industrial Center" as one of the "21 National Strategic Projects for Revitalization of Japan for the 21st Century". It states: "With the aim of reviving Japan as an Asian industrial center, we will consider an incentive system containing taxation measures to invite foreign firms to set up their Asian head offices and R&D bases in Japan, which are linked to the degree of contribution to employment of highly-skilled personnel. We will aim to put this system into operation from fiscal 2011." Through such measures, the Japanese government aims to increase the competitiveness of companies operating in Japan and bring about arise in employment. In addition, by inviting foreign firms that bring high value-added products and services into Japan, the government aims to double employment by foreign firms and also double direct inward investment, according to the document.

(2) "Inward Investment Promotion Program"

The sharp appreciation of the Yen in 2010 raised concern about the deterioration of Japan's locational competitiveness. In response, we launched an "Inward Investment Promotion Round-Table Council" as a joint effort by the government and the private sector with the aim of attracting investment from both inside and outside Japan. This council, based on the discussions involving relevant governmental agencies, the industrial and labor sectors, and local governments, issued the "Inward Investment Promotion Program" in November 2010.

(3) Efforts to promote Japan as an Asian business center (The Ministry of Economy, Trade and Industry)

The government submitted the "Bill on Special Measures for the Promotion of Research and Development by Certified Multinational Enterprises" to the 177th session of the Diet in February 2011. The bill provides for incentives for multinational enterprises such as reduced corporate taxes and lower patent fees for new R&D projects, as well as for companies with headquarters in Japan.[6] (see Figure 5-3-3-1).

Amid concern that the earthquake disaster might result in a decrease in domestic investment, in April 2011 METI announced that it selected five projects to fall under the "Subsidy Program for Projects Promoting Asian Site Location in Japan", which supports the establishment of new high-value-added R&D sites in Japan in a wide variety of fields such as next-generation solar cells, IT and pharmaceuticals.

Continued efforts are important to promote Japan as an Asian business center and enhance Japan's attractiveness to foreign companies, with a view to bringing foreign companies' Asian headquarters and R&D centers to Japan.

Figure 5-3-3-1 Summary of the "Bill on Special Measures for the Promotion of Research and Development by Certified Multinational Enterprises"

○ To support R&D that the global corporations licensed under the "Bill on Special Measures" newly perform in Japan, we will take the following measures.

(1) Corporate tax reduction (corporate tax will be lowered to 29% for 5 years)
(2) Income tax reduction (lowered to the same level as Japanese companies)
(3) Shortening of the investment procedures under the Foreign Exchange and Foreign Trade Act
(4) Lowering of patent registration fees and patent enquiry charges
(5) Exception from the "Small- and Medium-sized Business Investment & Consultation Companies Act" (this includes small- and medium-sized medium and small-size corporations with capital of ¥300 million or more)

(4) Strategy to Prevent the Hollowing-Out of Industry and for Developing Overseas Markets ("Guideline on Policy Promotion" decided by the Cabinet)

The Guideline on Policy Promotion, decided by the Cabinet on May 17, 2011, refers to the

[6] "Headquarters operations" (toukatsu jigyou) refers to operations such as deciding on subsidiaries' business policies.

“Strategy to Prevent the Hollowing-Out of Industry and for Developing Overseas Markets”, and announced that it would restart measures for domestic investment promotion which had been stalled due to the earthquake disaster.

Thus, it was decided that the government would proceed with the reexamination of initiatives such as the “Inward Investment Promotion Program” and “Promotion of Japan as an Asian Industrial Center”. In addition to immediate responses (restoring and reconstructing supply chains, improving Japan’s image, etc.), the government would also explore a number of other measures, including promoting the competitiveness of business locations, creating economic and industrial structures which are fortified against enormous risks, and promoting strategic innovations that will pave the way to a better future.

Japan is capable of contributing to the growth of emerging economies in Asia and other regions through trade and investment. Through such contributions Japan can share the fruits of economic growth with emerging countries. However, in spite of all the measures taken to cope with the shocks resulting from the earthquake disaster, concern remains regarding Japan’s locational competitiveness.

In view of this growing concern, it is even more urgent to take fundamental strategic measures. In order to attract globally operating companies’ regional headquarters and R&D centers to Japan, the government aims to provide stronger incentives. It is very important to implement the “Strategy to Prevent the Hollowing-Out of Industry and for Developing Overseas Markets” based on this perspective.